

**FINAL REPORT
OF THE
INTERIM STUDY COMMITTEE ON
CORPORATE TAXATION**



**Indiana Legislative Services Agency
200 W. Washington Street, Suite 301
Indianapolis, Indiana 46204**

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A copy of this report is available on the Internet. Reports, minutes, and notices are organized by committee. This report and other documents for this Committee can be accessed from the General Assembly Homepage at <http://www.state.in.us/legislative/>.

I. STATUTORY AND LEGISLATIVE COUNCIL DIRECTIVES

The Indiana General Assembly enacted legislation (P.L.81-2004, SECTION 64 (HEA 1365)) directing the Committee to do the following:

Study the use of passive investment corporations by companies doing business in Indiana.

II. INTRODUCTION AND REASONS FOR STUDY

The introduced version of HB 1365 (2004) and the version of HB 1365 (2004) that initially passed the House of Representatives contained a provision that would have required entities that deducted certain expenses for federal tax purposes to add the expenses to their federal taxable income for the purposes of determining taxable income under the Indiana Adjusted Gross Income Tax law and the Indiana Financial Institutions Tax law. The expenses subject to an add-back involved expenses incurred as a result of using a trademark, patent, or other intangible owned by a passive investment company (PIC) owned in substantial part by the company incurring the expenses. The measure was deleted from the enacted bill. The enacted bill established the Interim Study Committee on Corporate Taxation to further study the issue.

III. SUMMARY OF WORK PROGRAM

The Committee met three times. In its first meeting, the Committee took testimony seeking the reasons for inclusion of various provisions in HB 1365 (2004), including provisions related to the use of passive investment corporations by companies doing business in Indiana. The Committee received background information from the Legislative Services Agency concerning corporate taxation in Indiana. The Committee also heard testimony concerning the value of joining the Multistate Tax Commission. In its second meeting, the Committee took additional testimony concerning the issue of passive investment companies and the Multistate Tax Commission. In its third meeting, the Committee considered proposed legislation and adopted a final report.

IV. SUMMARY OF TESTIMONY

The Committee heard testimony from the Department of State Revenue concerning the taxation of interrelated companies that include a passive investment company as part of the business group and the effect that the version of HB 1365, as passed by the House of Representatives in the 2004 Session of the General Assembly, would have on state tax policy.

The Department indicated that the term "passive investment company" or "PIC" is a popular term that refers to an entity, ordinarily a corporation, that receives a substantial percentage of its revenues from income that qualifies as a "passive investment" under the tax laws applicable to the entity. The term is sometimes used as a synonym for a Delaware Holding Company (DHC). A DHC is a corporation that is organized in Delaware and is exempt from the Delaware

corporate income tax under 30 Del. C. 1902(b)(8), which exempts corporations whose activities within Delaware are confined to:

- (1) the maintenance and management of their intangible investments or of the intangible investments of corporations or statutory trusts or business trusts registered as investment companies under the Investment Company Act of 1940, as amended (15 U.S.C. 80a-1 et seq.); and
- (2) the collection and distribution of the income from such investments or from tangible property physically located outside Delaware.

However, a PIC can be formed in any state or foreign country and does not need to be 100% exempt from taxation in the jurisdiction where it is formed. For example, the term is broad enough to cover Delaware Headquarters Management Corporations (HMC), which also receive favorable tax treatment under Delaware law (30 Del. C. 1601 *et seq.*).

The types of investments that qualify as "passive investments" depend upon the particular language of the statutory definition applicable to the entity receiving the income. By way of example, Delaware's DHC tax exemption law covers the collection and distribution of income from:

- (1) intangible investments; and
- (2) tangible property located outside Delaware.

The term "intangible investments" is defined in the DHC tax exemption law to "include, without limitation, investments in stocks, bonds, notes and other debt obligations (including debt obligations of affiliated corporations), patents, patent applications, trademarks, trade names and similar types of intangible assets."

A business that operates in a state that:

- (1) has an income based tax;
- (2) is not a unitary state requiring related companies to file a consolidated or combined return;
- (3) owns passive investment assets, such as trademarks, patents, or other intangible property or a large portfolio of accounts receivable, mortgages or other loans; and
- (4) has a sophisticated management structure capable of managing a multistate company;

can obtain a substantial state tax advantage by forming a PIC in another state or country.

To realize the tax savings, the business forms the PIC in a state that either:

- (1) has no income tax or a minimal income tax on passive investment income; or
- (2) requires the business to file a consolidated or combined return with its operating affiliates.

The corporation operating in Indiana then either takes a loss on the transfer of the passive investments to the PIC or takes a business deduction for payments made to the PIC for the right to continue using the passive investments after the transfer. The corporation operating in Indiana may also obtain additional business deductions for interest paid on loans made by the passive investment company to the corporation operating in Indiana. The money loaned may be the money paid to the passive investment company by the corporation operating in Indiana.

The losses and deductions reduce the amount of adjusted gross income that would otherwise be taxable in Indiana. The Department gave five examples of businesses that had reduced their Indiana taxable income through the use of a PIC. The following table shows the tax consequences:

Tax Advantages Accruing to Five Multistate Corporations Through the Use of a PIC			
Business Type	Total Federal Taxable Income Before PIC Deduction (dollars)	Deduction for Royalties Paid to a PIC (dollars)	Resulting Reduction in Indiana Tax (dollars)
Clothing and household goods retailer	195,879,855	213,016,815	1,140,705
Manufacturer and wholesaler of vehicles	4,455,646,418	3,804,801,000	\$10,1222,673
Bank holding company	654,254,350	241,316,127	900,471
Manufacturer of transmissions, engines and automotive accessories	11,364,474	6,787,301	310,326
Automotive parts and accessories retailer	285,489,582	143,727,285	519,346

The Department indicated that the Department is challenging these deductions through the audit process. They indicated that they use their authority to restate a taxpayer's income to establish an equitable allocation and apportionment of the taxpayer's income to Indiana. They noted that the audit process is time consuming and expensive for both the Department and the taxpayer. They further noted that these cases are very fact sensitive and it is difficult to predict what outcome

will occur in any particular case.

Mr. Jeffrey Sherman, Legal Counsel for the Ohio Department of Taxation, discussed Ohio's experience with a statutory provision that disallows income tax deductions to interrelated companies for expenses related to a PIC. Ohio estimates that the law increased tax revenue by about \$50,000,000 per year. Mr. Sherman indicated that the Ohio language has been in effect since 1991. Mr. Sherman said it addressed an issue of fundamental fairness in the way the tax laws are administered. He has not seen any adverse economic development effect from the application of the law. The Ohio Chamber of Commerce has indicated that although they oppose any expansion of the law they do not have a problem with the 1991 law.

Twenty-eight states have specific laws that limit the usefulness or availability of this tax planning device. Sixteen states have mandatory combined or consolidated reporting laws that require a related group of businesses to file a combined or consolidated return (*i.e.*, a return that aggregates the adjusted gross income of all of the business entities in the unitary group and eliminates, in calculating adjusted gross income, all income and deductions from transactions between entities that are included in the unitary group). They are Alaska, Arizona, California, Colorado, Hawaii, Idaho, Illinois, Kansas, Maine, Minnesota, Montana, Nebraska, New Hampshire, North Dakota, Oregon and Utah.

Eleven other states have laws that disallow some or all deductions for a broad range of related company transactions involving a PIC. Ohio was the first state to enact such legislation (Ohio Rev. Code section 5733.042), followed by Connecticut in 1998 (Conn. Gen. Stat. section 12-218c), and, in 2001, Alabama (Ala. Rev. Stat. section 40-18-35), Mississippi [Miss. Code Ann. section 27-7-17(2)], and North Carolina (N.C. Gen. Stat. section 105-130.7A). Most recently, anti-holding company provisions were enacted by New Jersey in 2002 (N.J. Rev. Stat. section 54:10A-4.4) and Massachusetts (Mass. Gen. Law, Ch. 63, section 31I), New York (N.Y. Tax Law section 208), Arkansas (Ark. Code section 26-51-423) in 2003 and Maryland (Md. Code Ann. Tax-Gen section 10-306.1) and Virginia (Va. Code Ann. section 58.1-402) in 2004.

Iowa has a law that requires financial institutions to add back licensing fees paid to a subsidiary. (Iowa Code Ann. section 422.61 (West 1998)).

Expense disallowance legislation has been proposed in Indiana (HB 1365, 2004) and such states as Missouri (most recently, HB 969, 2004), Pennsylvania (HB 1305, 2003), Rhode Island (SB 794, 2003), Texas (HB 3146, HB 2425, 2003), and Wisconsin (AB 391, 2003).

Five additional states (Nevada, South Dakota, Texas, Washington, Wyoming) do not have a corporate income tax law. As a result there is no income tax against which deductions of this type can be applied in these states.

Mr. Joe Crosby, Legislative Director of the Council on State Taxation (COST), and others testified on the other approaches states have taken in regulating PICs. They suggested that the

Committee look at legislation either proposed or passed in Ohio, Missouri, Tennessee, and Virginia. The information provided by Mr. Crosby shows that only:

- (1) Maryland, North Carolina, Oregon, and Utah receive a lower share of state and local taxes from business than Indiana;
- (2) Oregon and Utah impose lower state and local business taxes per employee than Indiana;
- (3) Georgia, Massachusetts, North Carolina, Oregon, Utah, and Virginia impose lower state and local business taxes per dollar of private sector economic activity than Indiana; and
- (4) Delaware, Georgia, North Carolina, Oregon, Utah, and Virginia impose lower state and local business per dollar of capital income than Indiana.

Mr. Mark Richards, Partner at Ice Miller, and others spoke in favor of allowing PIC deductions in at least some cases. They indicated that there are legitimate business reasons for establishing a PIC. Often cited business purposes for the formation of a passive investment company are to:

- (1) provide better centralized management of trademarks and trade names;
- (2) protect trademarks and trade names from creditors of the transferor;
- (3) avoid a hostile takeover of the transferor;
- (4) maximize "value" of trademarks and trade names;
- (5) allow future licensing of trademarks and trade names;
- (6) increase borrowing potential;
- (7) facilitate acquisitions of businesses; and
- (8) obtain the protections of Delaware's corporate laws and legal system.

Data compiled by Council on State Taxation indicates that Indiana has the lowest total tax burden on businesses of any state in the Midwest. Of the six states with a lower total tax burden, four have specific statutes that limit the use of passive investment companies to transform taxable income into nontaxable income. The total tax impact in Indiana of limiting this tax planning device is unlikely to substantially change the Indiana's ranking relative to other states. However, the Committee received evidence that the tax rate imposed on financial institutions is substantially higher than the tax rate imposed on financial institutions by Illinois, Michigan, and Kentucky. Community bankers testified that retention of PIC deductions is necessary to make them competitive.

Mr. Mark St. John, Lambda Consulting, spoke in support of regulating PICs. He said he felt tax sheltering was unfair and shifted the tax burden to individuals and to other companies that were not in a position to take advantage of the tax shelter.

Shaw Friedman, an attorney from LaPorte, Indiana, presented information on the Multistate Tax Commission. The Multistate Tax Commission is an organization of state governments that works with taxpayers to administer, equitably and efficiently, tax laws that apply to multistate and

multinational enterprises. Created by an interstate compact, the Commission was established to do the following:

- (1) Encourage tax practices that reduce administrative costs for taxpayers and states alike.
- (2) Develop and recommend uniform laws and regulations that promote proper state taxation of multistate and multinational enterprises.
- (3) Encourage business compliance with state tax laws through education, negotiation and enforcement.
- (4) Protect state fiscal authority in Congress and the courts.

Forty-five states and territories, including the District of Columbia, participate in the Multistate Tax Commission as compact members. Indiana has been a member of the Multistate Tax Commission in the past but is not a member currently.

Programs provided by the Multistate Tax Commission that might assist Indiana in collecting taxes from multistate and international enterprises include the following:

- (1) Uniform Sales and Use Certificate.
- (2) Multistate Voluntary Disclosure Program.
- (3) Sales/Use Tax Registration Forms.
- (4) Taxpayer-Initiated Joint Audits.
- (5) Alternative Dispute Resolution.
- (6) Combined Registration Critical Documents.

The member states establish the Commission's budget based on their judgment of the necessary level of funding for Commission activities. Commission receipts are distributed in relative terms among the states on the basis of certain tax sources.

V. COMMITTEE FINDINGS AND RECOMMENDATIONS

The Committee made the following findings of fact concerning the use of passive investment corporations by companies doing business in Indiana:

- (1) A multistate or multinational business can use a passive investment company (PIC) that it directly or indirectly owns to eliminate a substantial portion of the state tax that it would otherwise pay on income earned in Indiana without incurring any additional tax expense in any other jurisdiction.
- (2) Related company transactions of this type differ from the typical franchise expenses that a business may incur because the same people directly or indirectly own both the entity incurring the expense and the entity receiving the income.

(3) This tax planning device treats taxpayers with similar businesses differently depending upon the manner in which they are organized rather than the substance of their business.

(4) Indiana businesses that do not have the capability to use a PIC or do not use a PIC shoulder the burden of paying taxes that businesses with a PIC escape. The average small business and the average individual taxpayer are likely to view the tax advantages given by these arrangements to the few taxpayers who are capable of maintaining an out of state PIC as fundamentally unfair.

(5) A majority of the states have structured their income tax codes to make it impractical or illegal for related companies to use this tax planning device.

(6) Enactment of legislation establishing clear guidelines concerning when expenses incurred in related company transactions are and are not deductible would reduce expensive and time consuming litigation and bring certainty to Indiana tax law.

(7) Data compiled by the Council on State Taxation indicates that Indiana has the lowest total tax burden on businesses of any state in the Midwest. Of the seven states in the nation listed as having a lower total tax burden than Indiana on at least one chart compiled by COST, five have tax laws that limit the use of passive investment companies to transform taxable income into nontaxable income. The total tax impact in Indiana of eliminating or limiting this tax planning device is unlikely to substantially change the Indiana's ranking relative to any of these other states.

(8) In contrast, individual businesses may have a substantial change in their tax liability if Indiana law is changed to eliminate the deductibility of some or all related company deductions involving a PIC. In particular, the Committee has received evidence that the Indiana tax rate imposed on financial institutions is substantially higher than the tax rate imposed on financial institutions by Illinois, Michigan, and Kentucky. This circumstance may justify a comprehensive review of the Financial Institutions Tax.

The Committee made the following recommendations concerning the use of passive investment corporations by companies doing business in Indiana:

Be it resolved, that the Committee recommends that the General Assembly enact legislation substantially similar to PD 3412 (2005) as amended by the Committee to delete the provisions concerning the burden of proof.

The Committee made the following findings of fact concerning the Multistate Tax Commission:

(1) The Multistate Tax Commission is an organization of state governments that works

with taxpayers to administer, equitably and efficiently, tax laws that apply to multistate and multinational enterprises. Created by an interstate compact, the Commission was established to do the following:

- (A) Encourage tax practices that reduce administrative costs for taxpayers and States alike.
- (B) Develop and recommend uniform laws and regulations that promote proper state taxation of multistate and multinational enterprises.
- (C) Encourage business compliance with state tax laws through education, negotiation and enforcement.
- (D) Protect state fiscal authority in Congress and the courts.

(2) Indiana has been a member of the Multistate Tax Commission in the past but is not a member currently.

(3) Programs provided by the Multistate Tax Commission that might assist Indiana in collecting taxes from multistate and international enterprises include the following:

- (A) Uniform Sales and Use Certificate.
- (B) Multistate Voluntary Disclosure Program.
- (C) Sales/Use Tax Registration Forms.
- (D) Taxpayer-Initiated Joint Audits.
- (E) Alternative Dispute Resolution.
- (F) Combined Registration Critical Documents.

The Committee made the following recommendations concerning the Multistate Tax Commission:

Be it resolved, in accordance Legislative Council Resolution 04-02, SECTION 10 (May 19, 2004) establishing study committee policies, the Committee recommends that the Department of State Revenue evaluate the benefits of becoming an active participant in the Multistate Tax Commission, and, if the Department determines membership to be beneficial, include sufficient money in its budget request to become a member.

WITNESS LIST

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